DEPARTMENT OF STATE REVENUE
LETTER OF FINDINGS NUMBER: 03-0062
Adjusted Gross Income Tax
For the Years 1996-1999

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ISSUES

I. Business / Non-business Classification – Adjusted Gross Income Tax.

Authority: Ind. Code § 6-3-1-20; Ind. Code § 6-3-1-21; Ind. Code § 6-3-2-2; *May Dep't Stores Co. v. Indiana Dep't of State Revenue*, 749 N.E.2d 651 (Ind. Tax 2001); *Hoechst Celanese Corp. v. Franchise Tax Board*, 22 P.3d 324 (Cal. 2001); *Jim Beam Brands Corp. v. Franchise Tax Board*, 34 Cal. Rptr. 3d 874 (Cal. Ct. App. 1st Dist. 2005); *Times Mirror Co. v. Franchise Tax Board*, 162 Cal. Rptr. 630 (Cal. Ct. App 2nd Dist. 1980)

STATEMENT OF FACTS

Taxpayer is a corporation which filed a unitary tax return on behalf of several affiliates. During 1996, Taxpayer sold several businesses. The largest dollar amount was realized from the sale of Group W, which itself consisted of several subsidiaries.

In addition, an affiliate of Taxpayer, Sub A, sold an interest in Unrelated S, a business whose subsidiary, Unrelated N, was engaged in management of environmental emergencies on behalf of Sub A. Sub A owned options and participation options in Unrelated S. In 1996, Sub A exercised its options in shares of Unrelated S. Sub A then sold its shares of Unrelated S. While Sub A contracted with Unrelated N to provide federally mandated services on behalf of Sub A, Sub A never owned or even had the right to own more than twenty percent of Unrelated S.

Further, Taxpayer sold an interest in an Austrian partnership that it had purchased, apparently for the sole purpose of allowing Taxpayer's chairman to obtain an Austrian passport. Finally, Taxpayer purchased shares of several corporations that Taxpayer considered to be possible takeover targets; however, Taxpayer purchased less than a five percent interest in the targets. As a result of owning shares in these takeover targets, Taxpayer received dividends from the target corporations.

Meanwhile, Taxpayer also owned Group E and stock in Sub C, a company designed to manage Taxpayer's health care liabilities. Group E consisted of several subsidiaries. In 1996, the operations of Group E were reorganized into an LLC. As a result of the reorganization and a subsequent distribution of the LLC to Company R, Taxpayer incurred a significant loss. Also in 1996, ten percent of the stock of Sub C was sold to an unrelated third party. The sale of Sub C stock resulted in a substantial loss.

In 1997, another company, Sub G, sold its remaining gas contracts, terminating its gas marketing business activities, incurring a substantial gain. Taxpayer received additional dividends from potential takeover targets.

On its Indiana tax returns for the years in question, Taxpayer reported all the income and losses in question as nonbusiness income. Upon Department audit, the Department determined that the items should have been classified as business income and assessed additional tax. Taxpayer filed a protest of the items that resulted in gains; however, as part of its protest, it stated that the items that resulted in losses were in fact business income. A hearing was held with respect to the protest.

I. Business / Non-business Classification – Adjusted Gross Income Tax

DISCUSSION

Ind. Code § 6-3-1-20 provides:

> The term "business income" means income arising from transactions and activity in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management and disposition of the property constitutes integral parts of the taxpayer's regular trade or business.

Conversely, Ind. Code § 6-3-1-21 provides that "nonbusiness income" means all income other than business income.

Under the provisions of Ind. Code § 6-3-2-2, business income of a corporation is subject to apportionment to Indiana, while nonbusiness income is generally allocable to the corporation's domicile.

In *May Dep't Stores Co. v. Indiana Dep't of State Revenue*, 749 N.E.2d 651 (Ind. Tax 2001), the court determined that the definition of business income encompassed two tests. The first test, the transactional test considers

> (1) the frequency and regularity of similar transactions;
> (2) the former practices of the business; and
> (3) the taxpayer's subsequent use of the income.

Id. at 658-659.

In *May*, May Department Stores ("May") owned a several large department store chains purchased a rival department store chain. As a result of the purchase, an antitrust case was launched against May. In settlement of the antitrust claim, May sold the assets of one of its divisions, Home. As a result of Home's asset sale, May realized a gain that it treated as nonbusiness income, allocable to May's domicile; however, the Indiana Department of State Revenue determined that the income was business income apportionable to Indiana and other states. The court held that, because the sale of the assets was a one-time, extraordinary transaction, the sale did not meet the transactional test for business income. *Id.* at 664

Applying the test from *May*, the sales of Taxpayer's interests in various divisions and other companies generally did not meet the transactional test due to their extraordinary nature. However, with respect to the dividends received from the potential takeover target corporations, the dividends met the transactional test. As part of Taxpayer's regular business, Taxpayer bought (and presumably sold) shares in potential takeover targets. The receipt of dividends from takeover targets- a consistent and ongoing activity of Taxpayer- was in contrast to May that sold the assets in one division as a one-time transaction. Accordingly, the dividends met the transactional test for business income.

The second test, the functional test, "dictates that acquisition, management, use or rental, *and* disposition of property must constitute integral parts of regular business operations." *Id.* at 660 (emphasis added). In *May*, the court noted that the sale of the assets of the division in question was done to benefit a competitor, rather than May. As a result, the sale could not have been an integral part of May's business, and therefore the sale failed to meet the functional agreement. *Id.* at 665.

First, with respect to the sale of Group W (and Sub G's gas contracts, which parallels Group W but will not be discussed separately), Taxpayer operated this business for several years as part of its core business of energy production. Taxpayer had used Group W for the production of business income and business deductions. Further, while Taxpayer was no longer engaged in the mining business in certain states, Taxpayer admits that it was engaged in the mining business in other parts of the country, and uses this argument to justify treating losses from its partial sale of Group E as *business* losses. While the Department acknowledges that different methods may be used to mine the coal in different regions of the United States, this does not change the fact that Group W, its management, its extraction of coal, and ultimately its sale were part of Taxpayer's regular business operations. Unlike May, which had to sell the assets of Home to benefit a competitor, Taxpayer sold Group W as part of a regular business decision to benefit itself. The operation and sale of Group W was an integral part of its overall business, unlike May that had to sell the assets of Home to *prevent* helping itself and, in fact, help its competition.

Finally, if Taxpayer's argument is to be understood, the sale of all of a business interest renders a gain a nonbusiness gain, while a sale of ten percent renders the sale a business gain (or loss, as occurs in this case). Apparently, somewhere in between these numbers exists a point where gains change their character, and an influx of income suddenly switches from one side of Taxpayer's tax ledger (business income) to the other side (nonbusiness income). Absent a clear statutory, regulatory or other guidance as to when this switch occurs, Taxpayer has not carried its burden of showing the error of the assessment. As such, the income from the sale of the Group W was business income within the meaning of Ind. Code § 6-3-1-20.

Furthermore, while Indiana has considered this issue in one particular set of circumstances, California has considered the issue with respect to the sale of subsidiaries in the normal course of a taxpayer's business. While California law is not binding authority in Indiana, California's constructions are noteworthy because its statutes and rulings formed the basis of the Uniform Division of Income for Tax Purposes Act (UDITPA), *Hoechst Celanese Corp. v. Franchise Tax Board*, 22 P.3d 324, 334-335 (Cal. 2001), and Indiana has generally based its corporate tax statutes on UDITPA. *May*, 749 N.E.2d at 651. In *Jim Beam Brands Corp. v. Franchise Tax Board*, 34 Cal. Rptr. 3d 874 (Cal. Ct. App. 1st Dist. 2005), Jim Beam owned all the shares of a subsidiary, Clear Spring, who in turn owned all the shares of yet another company, Taylor Foods. In 1987, Clear Spring sold its shares in Taylor Foods. The reason given for the sale was that Taylor Foods did not fit into Jim Beam's long-term plans. The proceeds were distributed from Clear Spring to Jim Beam and further to Jim Beam's parent. Jim Beam had classified the income as nonbusiness income allocable to Jim Beam's Kentucky domicile. Previously, Jim Beam had treated Taylor Foods as part of its unitary group and had treated its income and deductions as business income or deductions. However, California sought to treat the income as apportionable to California.

The court looked at the whether the property itself was used for the production of income as an integral part of Jim Beam's operation, rather than just the disposition of that property. The court held that Taylor Foods itself was used to produce business income, and as a result the disposition of Taylor Foods was business income. *See also Hoechst Celanese* 22 P.3d at 343 (distribution of excess pension funds to preclude use by other corporations possible takeovers resulted in business income when the corporation had claimed its payments into the fund as business deductions); *Times Mirror Co. v. Franchise Tax Board*, 162 Cal. Rptr. 630 (Cal. Ct. App 2nd Dist. 1980) (disposition of a wholly-owned subsidiary held to be business income).

Here- just as Taylor Foods was part of Jim Beam's unitary business in *Jim Beam*- Group W was part of Taxpayer's overall unitary operation. Similarly, even though Jim Beam did not even retain the funds from the sale of Taylor Foods or continue to operate Taylor Foods, Taxpayer did not continue to operate Group W. Nevertheless, Group W was a part of Taxpayer's overall business. That it was sold as a part of Taxpayer's overall business plan did not change the character of the property in question. It was business property and remained business property even in its ultimate disposition.

In addition, with respect to its dividends from potential takeover targets, Taxpayer used its stake in these companies to decide whether to expand its operations. It decided either to offer to take over the target corporation or to refuse to buy it. While the operation of the target corporations was not part of its unitary business, the buying and selling of the target corporations was clearly integral to its core operations.

Further, with respect to the sales (or deemed sale) of portions of Group E and Sub C, it is clear that these corporations were part of its overall unitary business. Accordingly, the losses are business losses. However, if it is subsequently determined that the gains from Group W was nonbusiness gains, it would stand to reason that the losses from Group E and Sub C are nonbusiness losses, notwithstanding that the businesses were operated by Taxpayer after the sales of shares of these companies.

However, with respect to the sale of Taxpayer's interests in the Austrian partnership and in Unrelated S, Taxpayer has provided sufficient information to conclude that the assets were not part of its regular business operations, and therefore Taxpayer's protest is sustained on these issues.

FINDING

Taxpayer's protest is sustained with respect to its sale of Unrelated S and its interest in an Austrian partnership. Taxpayer's protest is otherwise denied.

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